AMEREN EXHIBIT NO. 14.0

ILLINOIS COMMERCE COMMISSION

DOCKET NO. 00-0802

REBUTTAL TESTIMONY

OF

KATHLEEN C. McSHANE

Submitted on Behalf

Of

UNION ELECTRIC COMPANY

d/b/a AmerenUE

AND

CENTRAL ILLINOIS PUBLIC SERVICE COMPANY

d/b/a AmerenCIPS

FOSTER ASSOCIATES, INC.
Bethesda, MD 20814

May 18, 2001

1. Q **Please state your name and business address.**

A. My name is Kathleen C. McShane and my business address is 4550 Montgomery Avenue, Suite 350N, Bethesda, Maryland 20814.

2. Q. **Are you the same Kathleen C. McShane who submitted direct testimony on December 15, 2000 in this case?**

A. Yes, I am.

3. Q. **What is the purpose of your rebuttal testimony?**

A. I have been asked by Ameren to address several issues raised in the direct testimony of Staff Witness Michael McNally. Specifically, I will address:

1. The reasonableness of AmerenUE's proposed capital structure;
2. The reliability of the comparable earnings test;
3. The market/book adjustment to the DCF and CAPM test results; and,
4. The need for a minimum financing flexibility adjustment.

<u>**AmerenUE's Proposed Capital Structure**</u>

4. Q. **Mr. McNally rejects reliance on AmerenUE's own capital structure and recommends imputing a hypothetical capital structure including 46% common equity. Do you agree?**

A. No. In my opinion, the Commission should not impute a hypothetical capital structure unless the Company's own capital structure is outside the range of reasonableness for the Company's business risk and bond rating. For AmerenUE, this is not the case.

5. Q. How did you ascertain that AmerenUE's proposed capital structure is within a reasonable range?

A. I compared AmerenUE's common equity ratio with those maintained by both gas distributors and electric utilities, using the same industry data relied on by Mr. McNally, i.e., the financial data compiled by Standard & Poor's for the gas distribution and electric utility industries.

6. Q. If you used the same data source as Mr. McNally,[1] how have you arrived at a different conclusion?

A. Primarily because Mr. McNally focused on the industry means, whereas I looked at the individual company capital structure ratios within the industry groups. In addition, Mr. McNally looked only at the companies in the A category, and I considered all companies rated by S&P in the range of AA to A-.

7. Q. What was your rationale for including the AA/AA- companies in the analysis?

A. S&P rates AmerenUE A+. Inclusion of only companies in the A category ensures that the sample will include more companies that are rated lower than AmerenUE.

Consideration of companies rated from AA to A- will result in inclusion of companies rated one and two notches above AmerenUE, as well as one and two notches below, resulting in an approximate average rating of A+.

8. Q. Of the gas distributors and electric utilities, which group should be the primary basis of comparison?

A. The gas distributors, because they form the primary basis for Mr. McNally's conclusion regarding the cost of equity for AmerenUE's delivery service. Since the cost of equity captures both business and financial risk, the primary basis for comparison should be the industry whose common equity return serves as the principal proxy for the return applicable to AmerenUE's delivery service tariff.

9. Q Please summarize the results of your investigation of the individual capital structures maintained by the S&P gas distributors (for which the average appears at page 7 of Mr. McNally's testimony).

A. The supporting S&P data for the "Financial Medians: Gas Distribution" include 17 companies rated AA to A-. The average common equity ratio for all 17 companies is 50.1%; however, the upper quartile (5 companies) has an average common equity ratio of 58.9%, with a range of 50.7-66.0%. The average common equity ratio for the upper quartile of 58.9% is virtually identical to AmerenUE's common equity ratio of 58.2% (see attached Schedule 1). Hence,

[1] Standard & Poor's Financial Medians: Gas Distribution, and Financial Medians: Electric Utilities, at

the data show that AmerenUE's common equity ratio is well within the range maintained by gas distributors rated within two notches of the Company's S&P rating.

10. Q. Did you do a similar analysis for the electric utilities?

A. Yes. S&P's supporting data for the "Financial Medians: Electric Utilities" include the capital structure ratios of 98 companies rated between AA and A-. The average common equity ratio of the 98 companies is 45.5%; however, the upper quartile, which includes 24 companies (exclusive of Union Electric), has an average common equity ratio of 56.2%, with a range of 50.4-78.9% (see Schedule 2). As with the gas distributors, AmerenUE's common equity ratio is well within the range maintained by electric utilities rated between AA and A-.

11. Q. What conclusion have you drawn from the above data?

A. The data for both industries show that AmerenUE's common equity ratio is within the range maintained by its peers. Moreover, it is AmerenUE's own capital structure that has permitted its debt to be rated A+ by S&P. To reduce the common equity ratio to the level suggested by Mr. McNally would potentially endanger that rating. Consequently, there is no valid reason for the Commission to depart from reliance on AmerenUE's own capital structure for ratemaking purposes.

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www.ratingsdirect.com, July 7, 2000.

<u>Reliability of the Comparable Earnings Test</u>

12. Q. Mr. McNally recommends that the Commission should disregard my comparable earnings approach because, in the Commission Order Docket No. 99-0121, the Commission Order stated, "the Commission is of the opinion that the comparable earning method advanced by Ameren does not produce a reliable return for ratemaking purposes." What are your comments?

A. With specific regard to the conclusion of the Commission in the Order cited by Mr. McNally, in my view, it is timely for the Commission to revisit the rationale of the comparable earnings test as the industry moves into a more competitive environment. That trend underscores what should be a key focus of the determination of a fair and reasonable return, as held in <u>Bluefield Water Works & Improvement Co. v. Public Service Commission of West Virginia</u>, 262 U.S. 679 (1923): "a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties." The application of this principle needs to recognize that utilities are competing for capital not only with other firms in the same line of business, but with firms which operate in other types of businesses. To ensure that the returns available to utilities are indeed commensurate with those available on other investments of comparable risk, the return needs to be measured by reference to other than simply regulated firms.

The premise for looking to the comparable earnings test specifically relates to its relationship to the notion of opportunity cost. The comparable earnings test arises from the notion that capital should not be committed to a venture unless it can earn a return commensurate with that available prospectively in alternative ventures of comparable risk. Since regulation is a surrogate for competition, the opportunity cost principle entails permitting utilities the opportunity to earn a return commensurate with the levels achievable by competitive firms facing similar risk. The comparable earnings test, which measures returns in relation to book value, is consistent with the original cost rate base form of regulation. In fact, it is the only test which measures the return by reference to a base which is similarly measured.

The comparable earnings test is an implementation of the comparable earnings standard, as distinguished from the cost of attracting capital standard. The comparable earnings standard recognizes that utility costs are measured in vintaged dollars and that rates are based on accounting costs, not economic costs. In contrast, the cost of attracting capital standard relies on costs expressed in dollars of current purchasing power, i.e., a market-related cost of capital. In the absence of experienced inflation, the two concepts would be quite similar, but the impact of inflation has rendered them dissimilar and distinct.

The concept that regulation is a surrogate for competition may be interpreted to mean that the combination of an original cost rate base and a fair return should result in a value to investors commensurate with that of competitive ventures of similar risk. The fact that an original cost rate base provides a starting point for the application of a fair return does not mean that the original cost of the assets is a measure of their fair value. The comparable earnings standard, as well as the principle of fairness, imply that, if competitive industrial firms facing similar risk are able to maintain the value of their assets considerably above book value, the return allowed to utilities should not seek to maintain the value of utility assets -- as reflected in stock market prices -- at book value.

Market/Book Adjustment to DCF and CAPM Test Results

13. Q. Mr. McNally criticizes your market/book adjustment, citing the Commission's Amended Order from Docket No. 97-0351[2] and the Order from Docket No. 99-0121[3], and concluding that your argument regarding the need to make a market/book adjustment is "false". Please respond.

A. Mr. McNally rejects the need for a market/book adjustment on the basis of past Commission decisions, not on the basis of the merits of the adjustment. The fact

[2] "[the Commission does]not agree that, as stock prices have risen, the problems associated with reliance on the traditional DCF theory in rate cases also have increased," and that "[the Commission continues] to rely upon the traditional DCF approach."

[3] "the Commission has consistently used and adopted estimates based on DCF and CAPM models and has not been presented with any reason to depart from this practice."

that the Commission has not previously been convinced of the veracity of the argument does not, in and of itself, render the conclusion false.

The need to make a market/book adjustment to a return determined on the basis of discounted cash flow test (or CAPM) when market values are above book value is dictated by the following:

1. The DCF test is a market-based test; it produces a return (in percentage terms) which investors expect to earn on the market value of their investment;

2. As noted at page 4 of my evidence, if a stock trades at 170% of book value (e.g., $17.00 market price and $10.00 book value), a 10% DCF cost is equal to a $1.70 return on market value in <u>dollar</u> terms. If the 10% return expressed as a percent is applied to the $10.00 book value, then the return to the equity holder in dollar terms is only $1.00.

3. A failure to recognize in the DCF cost rate the significant deviation between market and book value is tantamount to concluding the appropriate market value <u>is</u> book value.

4. Neither legal/regulatory precedent nor economic theory prescribes that the fair value of the investment is book value. Regulatory precedent recognizes that regulation is intended to emulate competition. As discussed at Ameren Exhibits 4.3 and 5.3, pages 5-6, under competition equity market values tend to gravitate toward the replacement cost of the underlying assets. Absent inflation, the market value of firms operating in

a competitive environment would tend to equal their book value or cost. This is due to the economic proposition that, if the discounted present value of expected returns (market value) exceeds the cost of adding capacity, firms will expand until an equilibrium is reached, when the market value equals the replacement cost of the productive capacity of the assets.

However, the fact that inflation has occurred changes the above analysis. Under competition, the market value of a firm trends toward the current cost of its assets. The book value, by comparison, reflects the historic depreciated cost of the assets. Since there have been moderate to relatively high levels of inflation over the past two business cycles, one would expect the market value to deviate systematically from the book value.

For reliance on the DCF cost result to produce a return compatible with the premise that regulation is a surrogate for competition, the DCF cost must be adjusted to reflect the replacement/book value. In principle, this value should correspond to the long-run equilibrium market/book ratio. My application of the DCF test is compatible with that premise.

<u>**Financing Flexibility Adjustment**</u>

14. Q. Mr. McNally states that I have given no basis for the need for a minimum financing flexibility adjustment, and cites the revised Company response to FIN-5 which indicates that neither AmerenCIPS nor AmerenUE have any specific costs of issuing common equity for which they are requesting compensation. What are your comments?

A. Mr. McNally is incorrect when he states that I have provided no basis for the need for a minimum financing flexibility adjustment. In Ameren Exhibits 4.5 and 5.5, I stated,

> "The flotation cost allowance is intended to serve **two distinct** (emphasis added) but related purposes: first, to permit a company to recover all costs associated with issuing additional stock as required to meet its obligation to serve, at no less than book value per share, and thus without harming (diluting) the investment of existing shareholders, and second, to position the company at all times such that if it needs to issue additional equity to meet its obligation to serve, it can do so without harm to its existing shareholders."

Ameren Exhibit 4.5 and 5.5 also stated,

> "This total [of financing costs] gives no consideration to the fairness principle, which would recognize that competitive industrials have, in periods of moderate inflation, consistently been able to maintain the real value of their assets, as evidenced by market/book ratios significantly in

excess of 1.0. Utilities should not be precluded from achieving a level of financial integrity that gives some recognition to the tendency for industrial market values to equate to replacement costs and thus produce market/original cost book values significantly in excess of 1.0. This is not only a fairness argument, but an economic argument, inasmuch as it is the role of regulation to simulate competition, under which long-run market value should equate to the replacement cost of the productive capacity. The argument is even stronger when regulated utilities are also exposed to competition with other regulated utilities or alternative energy service providers."

The minimum financing flexibility adjustment is therefore warranted not only on grounds of fairness, but also on economic grounds, to avoid misallocation of resources. To ignore these principles in determining an appropriate financing flexibility adjustment is to ignore the basic premise of regulation.

Standard & Poor's Utilities Rating Service

Summary Financial Ratios for Gas Distribution Companies

For 12 months ended December 31, 1999.

Company Name	Corporate credit rating	STD/ cap. (%)	LTD/ cap. (%)	Pfd. stk. /cap. (%)	Com./ cap. (%)
Alabama Gas Corp.	A+	3.1	37.4	0.0	59.4
Atmos Energy Corp.	A-	25.8	36.3	0.0	37.9
Boston Gas Co.	A	8.9	38.2	4.5	48.4
Colonial Gas Co.	A	7.9	32.1	0.0	60.0
Commonwealth Gas Co.	A-	12.2	21.1	0.0	66.7
KeySpan Corp.	A-	4.4	35.9	1.8	57.9
Michigan Consolidated Gas Co.	A-	15.8	40.5	0.0	43.7
New Jersey Natural Gas Co.	A	13.9	35.7	0.0	50.4
Nicor Gas Co.	AA	24.2	28.9	0.6	46.3
Nicor Inc.	A+	25.4	26.5	0.4	47.8
Northwest Natural Gas Co.	A	10.8	41.0	3.7	44.5
ONEOK Inc.	A	17.0	34.3	0.0	48.7
Peoples Energy Corp.	A+	16.2	33.5	0.0	50.2
Piedmont Natural Gas Co. Inc.	A	9.8	40.0	0.0	50.2
Questar Gas Co.	A+	14.0	39.6	0.0	46.4
Southern Connecticut Gas Co.	A-	8.1	41.2	0.0	50.7
UGI Utilities Inc.	A-	21.0	33.3	3.9	41.8
All Companies Rated AA to A-					
Average		14.03	35.03	0.87	50.06
Median		13.90	35.90	0.00	48.69
Standard Deviation		6.98	5.51	1.57	7.29
Upper Quartile					
Average		22.68	40.46	2.89	58.94
Median		24.20	40.50	0.00	59.42

Standard & Poor's Utilities Rating Service

Summary Financial Ratios for Electric Utilities

For 12 months ended December 31, 1999.

Company Name	Corporate credit rating	STD/ cap. (%)	LTD/ cap. (%)	Pfd. stk. /cap. (%)	Com./ cap. (%)
Alabama Power Co.	A+	2.8	45.3	9.4	42.4
Allegheny Energy Inc.	A+	19.5	35.2	5.4	39.8
Allegheny Generating Co.	A+	14.8	41.8	0.0	43.4
Alliant Energy Corp.	A+	11.5	35.4	2.7	50.4
Ameren Corp.	A+	3.5	39.8	5.0	51.6
American Electric Power Co. Inc.	A-	15.4	46.6	1.2	36.8
Appalachian Power Co.	A-	8.4	51.7	1.3	38.6
Atlantic City Electric Co.	A-	4.9	52.0	6.7	36.4
Baltimore Gas & Electric Co.	A+	12.1	36.2	8.1	43.6
Black Hills Corp.	A	20.8	33.7	0.0	45.5
Boston Edison Co.	A-	10.4	38.6	5.8	45.2
Cambridge Electric Light Co.	A-	0.1	21.0	0.0	78.9
Carolina Power & Light Co.	A	5.3	44.1	0.9	49.7
Central Hudson Gas & Electric Corp.	A	9.5	37.4	6.2	46.9
Central Illinois Public Service Co.	AA-	13.2	38.7	6.3	41.9
Central Maine Power Co.	A-	9.6	16.0	4.9	69.5
Central Power & Light Co.	A-	14.4	39.9	4.8	40.9
Cincinnati Gas & Electric Co.	A-	9.3	37.9	0.7	52.2
Columbus Southern Power Co.	A-	2.5	49.8	1.3	46.4
Commonwealth Electric Co.	A-	4.9	25.0	0.0	70.1
Consolidated Edison Co. of New York Inc.	A+	8.0	43.9	2.6	45.5
Delmarva Power & Light Co.	A	6.3	49.4	8.5	35.9
Duke Energy Corp.	A+	3.7	41.1	6.9	48.3
Edison International	A	16.1	52.4	7.6	23.9
Empire District Electric Co.	A-	0.0	59.6	0.0	40.4
Florida Power & Light Co.	AA-	3.0	28.4	3.1	65.5
Florida Power Corp.	AA-	6.3	40.8	0.9	52.0
Florida Progress Corp.	A	6.6	44.8	6.9	41.7
FPL Group Inc.	A+	4.9	36.5	2.4	56.3
Georgia Power Co.	A+	9.6	32.7	9.8	47.9
GPU Inc.	A	15.6	50.8	3.6	30.1
Gulf Power Co.	A+	5.9	39.3	9.6	45.2
IDACORP, Inc.	A+	6.1	45.9	5.9	42.1
Idaho Power Co.	A+	6.2	46.6	6.0	41.3
IES Utilities Inc.	A+	9.5	45.0	1.4	44.1
Indiana Michigan Power Co.	A-	16.7	43.5	2.9	36.9
Indianapolis Power & Light Co.	AA-	3.2	41.4	3.9	51.5
Interstate Power Co.	A+	8.4	36.3	7.5	47.8
IPALCO Enterprises Inc.	A+	6.4	50.7	3.4	39.5
Jersey Central Power & Light Co.	A	3.5	40.1	7.5	49.0
Kansas City Power & Light Co.	A	17.4	32.6	9.0	41.0
Kentucky Power Co.	A-	21.2	38.3	0.0	40.5
Kentucky Utilities Co.	A-	9.4	35.2	3.3	52.1
LG&E Energy Corp.	A-	25.1	37.8	3.9	33.2
Louisville Gas & Electric Co.	A-	24.0	24.9	6.2	44.8
Madison Gas & Electric Co.	AA	7.5	41.1	0.0	51.4
Massachusetts Electric Co.	A+	7.2	37.3	1.2	54.3
Metropolitan Edison Co.	A	4.4	43.3	8.7	43.7
MidAmerican Energy Co.	A	13.6	32.8	7.9	45.7
Mississippi Power Co.	A+	10.1	37.1	7.7	45.2
Monongahela Power Co.	A+	7.5	37.1	9.1	46.3
Narragansett Electric Co.	A+	5.3	33.2	1.6	59.9
New England Electric System	A+	4.0	36.4	0.7	58.9

Standard & Poor's Utilities Rating Service

Summary Financial Ratios for Electric Utilities

For 12 months ended December 31, 1999.

Company Name	Corporate credit rating	STD/ cap. (%)	LTD/ cap. (%)	Pfd. stk. /cap. (%)	Com./ cap. (%)
New England Power Co.	A+	5.2	50.0	0.2	44.7
Northern Indiana Public Service Co.	A	11.0	39.7	5.8	43.5
Northern States Power Co.	AA-	14.8	46.6	4.1	34.5
Northern States Power Co. (WI)	AA	12.1	34.6	0.0	53.3
Northwestern Corp.	A+	3.1	49.4	5.8	41.7
NSTAR	A-	19.5	30.5	2.9	47.2
OGE Energy Corp.	A+	24.3	36.6	6.4	32.7
Ohio Power Co.	A-	8.7	41.0	0.9	49.4
Oklahoma Gas & Electric Co.	A+	9.0	48.8	0.0	42.2
Orange & Rockland Utilities Inc.	A+	16.4	38.4	0.0	45.3
Otter Tail Power Co.	AA-	1.3	38.2	7.3	53.2
Pacific Gas & Electric Co.	A+	7.6	40.6	3.6	48.1
PECO Energy Co.	A-	6.6	45.8	4.2	43.4
Pennsylvania Electric Co.	A	5.3	42.3	10.0	42.3
PG&E Corp.	A	12.7	40.6	4.7	41.9
Portland General Electric Co.	A	14.4	33.9	1.4	50.3
Potomac Edison Co.	A+	5.8	36.2	3.5	54.5
Potomac Electric Power Co.	A	6.8	53.4	4.2	35.6
PPL Electric Utilities Corp.	A-	10.9	58.0	7.3	23.8
PSI Energy Inc.	A-	10.4	46.4	2.8	40.5
Public Service Co. of Colorado	A-	11.7	41.3	4.7	42.3
Public Service Co. of Oklahoma	A-	9.7	35.6	7.8	46.8
Public Service Electric & Gas Co.	A-	21.8	32.2	7.1	38.9
Rochester Gas & Electric Corp.	A-	0.0	46.7	4.2	49.1
San Diego Gas & Electric Co.	AA-	2.8	37.5	4.4	55.3
Savannah Electric & Power Co.	A+	8.8	37.1	10.1	44.0
SCANA Corp.	A	13.2	36.3	1.7	48.8
Sempra Energy	A	5.7	39.9	3.5	50.9
South Carolina Electric & Gas Co.	A	10.7	35.2	1.9	52.2
Southern California Edison Co.	A+	17.0	39.3	4.8	38.9
Southern Co.	A	16.0	41.7	9.6	32.7
Southern Indiana Gas & Electric Co.	AA	11.5	35.6	2.9	50.0
Southwestern Electric Power Co.	A-	12.7	33.8	7.8	45.6
Southwestern Public Service Co.	A	10.8	36.8	6.1	46.3
St. Joseph Light & Power Co.	A-	12.5	36.4	0.0	51.1
Tampa Electric Co.	AA	17.0	33.0	0.0	49.9
TECO Energy Inc.	AA-	26.6	33.1	0.0	40.3
Union Electric Co.	AA-	0.3	40.5	4.9	54.3
Union Light Heat & Power Co.	A-	15.4	30.5	0.0	54.0
Virginia Electric & Power Co.	A	8.7	40.9	7.4	43.1
West Penn Power Co.	A+	10.0	59.8	14.1	16.1
West Texas Utilities Co.	A-	10.5	45.2	0.4	43.8
Wisconsin Electric Power Co.	AA-	7.6	43.2	0.8	48.4
Wisconsin Energy Corp.	A+	11.6	43.1	4.7	40.6
Wisconsin Power & Light Co.	AA-	14.5	33.0	4.8	47.7
All Companies Rated AA to A-					
Average		10.08	40.04	4.34	45.54
Median		9.40	39.70	4.20	45.50
Standard Deviation		5.91	7.50	3.23	8.83
Upper Quartile					
Average		18.09	49.63	8.51	56.23

Standard & Poor's Utilities Rating Service

Summary Financial Ratios for Electric Utilities

For 12 months ended December 31, 1999.

Company Name	Corporate credit rating	STD/ cap. (%)	LTD/ cap. (%)	Pfd. stk. /cap. (%)	Com./ cap. (%)
Median		16.70	49.40	7.90	53.25

Note: Union Electric Co. is not included in Upper Quartile calculations.